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Mr. GARN, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

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together with

ADDITIONAL VIEWS

On July 20, 1982, the Committee on Banking, Housing and Urban Affairs received this year's second "Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978" (Public Law 95-523) from the Board of Governors of the Federal Reserve System.

Three days of hearings on the Report and monetary policy were held by the Committee. On July 20, 1982, Federal Reserve Board Chairman Paul A. Volcker presented a statement and testimony to the Committee. On July 21, 1982, statements and testimony were received from Murray L. Weidenbaum, Chairman, the President's Council of Economic Advisers; Donald E. Maude, Chief Financial Economist and Chairman, Interest Rate Policy Committee, Merrill Lynch; and Leif H. Olsen, Chairman, Economic Policy Committee, Citibank, N.A. On July 27, 1982, statements and testimony were received from Beryl Sprinkel, Department of the Treasury, Under Secretary for Monetary Affairs and Steven M. Roberts, Director, Government Affairs, American Express Company.

MONETARY AGGREGATES

Chairman Volcker reported to the Committee that growth in the monetary aggregates so far in 1982 has been within, or only slightly above, their target ranges, for 1983, the Chairman announced the Federal Open Market Committee's tentative decision not to change the existing growth-rate targets. But given that the FOMC expects this year's growth in the aggregates to remain "around the top end of

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the ranges," the Chairman pointed out that next year's "tentative targets would of course be fully consistent with somewhat slower growth in the monetary aggregates in 1983."

To justify the decision not to proceed at this time with a gradual reduction of the growth-rate targets, Mr. Volcker pointed to his view of the likely impact of declining inflation and interest rates on monetary velocity and its reciprocal, the demand for cash balances or "money":

> The presistent rise in velocity during the past twenty years years has been accompanied by rising inflation and interest rates—both factors that encourage economization of cash balances. In addition, technological changes in banking—spurred in considerable part by the availability of computers—has made it technically feasible to do more and more business on a proportionately smaller "cash" base. . . . However, lower rates of interest and inflation should moderate incentives to exploit that technology fully. In those conditions, velocity growth could slow, or conceivably at some point stop.

Chairman Weidenbaum, while not objecting to the FOMC's decision not to lower the monetary aggregates' growth targets at this time, did restate the Administration's conviction that future reduction will be necessary to continue the progress now being made toward price stability and a level of interest rates that will permit sustained economic growth.

The point was raised that West Germany and Japan, with faster money growth than the United States, had achieved superior economic performance. Mr. Weidenbaum explained that West Germany and Japan could have faster money growth than the United States because their trends rate of velocity growth has been markedly lower than ours.

Secretary Sprinkel restated the Administration's position on the Federal Reserve's ability to control short-term volatility in money growth:

> I want to reiterate and emphasize that when we (in the Administration) say stable money growth, we do not mean precise week-to-week or even month-to-month control. There are too many factors over which the Federal Reserve has no control that cause temporary aberrations in the money stock to expect such precision. However, the Federal Reserve itself maintains that the average quarterly growth of M–1 can be controlled within a band of ±1 percent. Thus, on a quarterly basis, the Federal Reserve has the ability to keep M–1 within its announced target range.

The Banking Committee's last Monetary Policy Report urged the Federal Reserve "to continue to consider" using contemporaneous reserve accounting and a market-oriented discount rate as ways to improve short-run monetary control. The last Report also urged the Federal Reserve "to pursue consideration of proposals for changing the current practice of releasing seasonally-adjusted weekly M–1 money supply estimates," given that such currently-released weekly numbers have little real meaning but still can cause disruptive financial-market reactions.

Since that last Monetary Policy Report, the Federal Reserve has announced plans to stop releasing seasonally-adjusted weekly M–1 estimates as well as plans to try a form of contemporaneous reserve accounting. Chairman Weidenbaum told the Committee that the latter "should allow the Fed's open market operations to have a more immediate effect on total bank reserves and M–1." While the Federal Reserve has not announced the formal adoption of a market-oriented discount rate, movement in this administered rate have closely paralleled market rates in recent weeks.

Velocity

Mr. Maude argued that, because so much of the growth in M–1 this year has been in NOW accounts, reported data on growth in the aggregate have been misleading as to the tightness of monetary policy:

> Technically, M–1 is supposed to measure the level of "transactional" (or readily spendable) deposits and currency in the system. It is not supposed to include savings-type deposits or balances being built up for precautionary reasons. In the past, M–1 served its purpose well. However, with historically high interest rates and resulting financial innovations (i.e. NOW accounts) . . . , its ability to capture strictly transactional balances and to exclude savings balances has diminished significantly . . .
>
> In addition to capturing non-transactional savings-type deposits, there is reason to suspect that the stated M–1 measure has included non-transactional "precautionary" balances as well—especially over the November–January period.

Similarly, Mr. Maude argued that, because so much of the growth in M–2 has been in the form of interest credited, reported data on growth in this aggregate also have been misleading as to the tightness of monetary policy:

> M–2 growth has been overly stated by historically high interest rates and the growing proportion of its components earning market rates of interest . . . as high interest is credited to the M–2 components, it represents a transfer of funds from borrower to deposits included in M–2—not newly created money by the Fed or enhanced overall liquidity.

Stated another way, Mr. Maude was arguing that the public demand for money balances as measured by M–1 has increased as a result of the popularity of NOW accounts and the public demand for money balances as measured by M–2 has increased as a result of the growth in the relative importance of interest credited. Since by definition monetary velocity is the reciprocal of the demand for money, Mr. Maude also was arguing that velocity has been reduced by NOW accounts and high interest rates.

It should be noted that Mr. Maude's arguments that M–2 velocity has been reduced by high interest rates contrasts with Chairman Volcker's contention that declining interest rates are likely to depress velocity.

In any case, Chairman Weidenbaum cautioned against adjusting targets for monetary growth to accommodate suspected changes in velocity such as those Mr. Maude discussed. According to Weidenbaum:

> The justification given most frequently for temporary shifts in money growth by the Fed is that unstable demand for money requires fluctuations in the money supply. Without shifts in money growth, it is hypothesized, short-term changes in the demand for money would result in large and sudden swings in interest rates. This argument is essentially identical to the assertion that short-term variability in velocity justifies shifts in money growth.
>
> The problem with attempting to control the money supply in accord with perceived short-term shifts in money demand is that, while achievable in theory, it proves counterproductive in practice. It is usually difficult to determine at any point in time whether an apparent shift in the demand for money is due to a change in the demand for money relative to the pace of economic activity, or due to a change in the level of economic activity itself. . . . Past attempts by the Federal Reserve to offset hypothesized shifts in money demand and to control interest rates have led to variations in money growth which have exacerbated previous business cycles. An excessive focus on shifts in the short-term demand for money and their effects on interest rates have caused both money growth and inflation to accelerate. This was certainly true in the years between 1965 and 1980.

Chairman Weidenbaum specifically argued against accelerating money growth to offset a suspected decline in velocity because of the additional danger of the financial markets' misinterpreting the Federal Reserve's motivation:

> Due to uncertainty about the Fed's future actions, public expectations about future rates of monetary growth, and hence future inflation, have become more volatile in recent years as current money growth has become more volatile. This is understandable, since it is difficult to determine whether a deviation of money growth from a targeted growth path represents a temporary discrepancy or a fundamental change in the growth trend of money . . . when money growth strays above the target range, even temporarily, long term interest rates rise as both higher money growth and inflation are expected in the future.

Finally, Weidenbaum opposed altering monetary aggregate targets in light of suspected changes in velocity because, "deviations (in velocity growth) from trend tend to reverse themselves within a year."

Federal Reserve Independence

As evidence of the seriousness of the threat to the economy from Congressional proposals that would undermine the Federal Reserve's independence, Chairman Weidenbaum began his statement to the Committee by reemphasizing the importance of maintaining the Federal Reserve's independence:

> Both the Administration and the Fed believe that a gradual reduction in the growth of the money supply is the best policy for achieving price stability. This reduction is best accomplished when the Fed enjoys independence from the

> routine pressures of the political process, and understands unequivocally that its primary mandate is to attain and maintain price stability.

Asked about a specific proposal to add the Secretary of the Treasury to the Federal Reserve Board of Governors, Dr. Roberts responded, "I think that that would politicize the process of monetary policy . . ." Similarly, in a letter to the Committee subsequent to his testimony, Dr. Roberts opposed proposals to make the terms of the Fed Chairman and Vice-Chairman coterminous with the President's or even to lag the President's by a year:

> The Fed is under enough political pressure now. Even a one year lag would increase the control of the President and, therefore, potentially threaten the independence of the Fed.

ECONOMIC DEVELOPMENTS

Inflation and unemployment

Chairman Volcker brought the Committee very good news about progress on the inflation front:

> . . . the evidence now seems to me strong that the inflationary tide has turned in a fundamental way. In stating that, I do not rely entirely on the exceptionally favorable consumer and producer price data thus far this year, when the recorded rates of price increase (at annual rates) declined to 3½ and 2½ percent, respectively . . . What seems to me more important for the longer run is that the trend of underlying costs and nominal wages has begun to move lower, and that trend should be sustaintable as the economy recovers upward momentum.

Addressing the Committee's repeatedly-stated concerns over unemployment, Secretary Sprinkel voiced the Administration's own deep concern but reminded the Committee that much of today's unemployment can be traced to the structural imbalances in the economy caused by accelerating inflation in recent years:

> Some of the disruptions associated with the transition to a non-inflationary economy are of course being felt now. These hardships are not to be dismissed . . .
>
> The Administration realizes that even temporary economic disruptions have real consequences for people here and now . . . but it is a mistake to presume that all problems in the economy are the result of monetary restraint. In many cases, they are more properly characterized as long-term, structural problems . . . Many of our most serious sectoral problems today reflect the damage of a decade of rising inflation and interest rates.

Because the seeming benefits would prove transitory while the long-term costs would be real and high, Secretary Sprinkel cautioned against seeking short-term political advantage by trying to force the reported unemployment rate down with faster money growth:

> The record of the 1970's clearly shows that a little more money growth does not provide a lasting increase in production and employment. Any boost to production and employ-

> ment that comes from accelerating money growth is temporary, while the inevitable permanent effects are inflation and higher interest rates. Accelerating inflation, escalating interest rates, and the resulting deterioration of the incentives to save and invest are, in fact, powerful and pervasive deterrents to sustained growth. Also, it is folly to trust that faster money growth would now result in more production because various segments of the economy are operating at less than full capacity. The experience of the past fifteen years should be ample evidence that inflation is not a problem which arises only when the economy is fully employed. Sustainable economic expansion requires a financial system based on a reliable dollar and that means monetary discipline.

To the argument that growth in the monetary aggregates should be accelerated in light of the progress that has been made in bringing the federal budget under control, Chairman Volcker responded:

> . . . The (FOMC) Committee did not feel that the budgetary effort, important as it is, would in itself appropriately justify still greater growth in the monetary aggregates over time than I have anticipated. Indeed, excessive monetary growth—and perceptions thereof—would undercut any benefits from the budgetary effort with respect to inflationary expectations. We believe fiscal restraint should be viewed more as an important complement to appropriately disciplined monetary policy than as a substitute.

On the day of Chairman Weidenbaum's testimony before the Committee, the Commerce Department announced preliminary numbers showing positive economic growth in the second quarter of 1982, and Mr. Weidenbaum pointed to this announcement as possibly heralding the recession's end. Additional evidence that the economy is on the verge of a new expansion has come from subsequent sharp declines in interest rates and upward movement of the stock market.

Interest rates

Secretary Sprinkel again disabused the Committee of any notion that the Administration's policy since early 1981 has been "to fight inflation with high interest rates." The Secretary reminded the Committee that persistently high interest rates have been the legacy primarily of the inflationary monetary policies pursued prior to 1981:

> We do not advocate the use of high interest rates to fight inflation. High interest rates are the legacy of persistent inflationary money growth, not an element of anti-inflationary monetary policy. Stubbornly high interest rates are the inevitable result of letting inflation occur in the first place.

Before explaining to the Committee why interest rates failed to fall as quickly as inflation, Mr. Olsen first credited the supporters of slower money growth since 1981 with the success that has been achieved in fighting inflation:

> . . . the monetary authorities should be credited with success in reducing inflation from 9–10 percent in 1981 to an estimated 6–7 percent in the current calendar year. Inasmuch as the Administration has explicitly supported this objec-

tive of monetary policy, it, too, should be commended for the cooling of inflation.

Mr. Olsen effectively refuted the mistaken belief that interest rates have been held high by the same slowdown in money growth that has produced the gains toward price stability. Rather, Olsen's prepared statement tied the persistence of high interest rates directly to the credibility of the long-term commitment to slowing money growth:

> Businessmen are also plagued by uncertainty when they look at the abortive anti-inflationary efforts that litter the political landscape of the past 15 years. Why, they ask, should this episode be any different. It is only a matter of time before monetary policy will have to yield to the political pressures for the reacceleration of money growth. The unwillingness to buy long-term bonds is a manifestation, not only of the losses that have been inflicted on investors by accelerating inflation over the past 15 years but the fear that this history will be repeated.

Responding to a question, Mr. Olsen noted:

> Apart from the fact that accelerating inflation over the past 15 years eroded the value of fixed-rate obligations, the acceleration in money growth in the second half of 1980 appears to have been particularly damaging to the credibility of the fight against inflation.
>
> We saw bond prices plummet and long-term interest rates, including mortgage rates, rise very rapidly in the second half of 1980. In the winter of 1980–81, in debates held around the investment policy committees and finance committees of countless financial firms across the country, the dominant view that emerged was that long-term fixed-rate lending had lost its economic legitimacy.
>
> There were explicit decisions to substantially back away from the purchase of such investments, in some cases, in totality. Those resolutions continue to hold at many of those financial firms.

Also addressing the credibility problem, Secretary Sprinkel told the Committee that "Periodic calls for the Fed to loosen the monetary spigot . . . serve to exacerbate the credibility problem."

CONCLUSIONS

Pursuant to the requirement in the Full Employment and Balanced Growth Act for a report to the Senate by the Committee on Banking, Housing, and Urban Affairs stating its "views and recommendations" regarding the Federal Reserve's Monetary Policy Report, the Committee finds:

(1) Significant declines in interest rates, continued progress toward price stability and emerging signs of an upturn in the real economy have been the results of the Federal Reserve's persisting with its policy of seeking a gradual reduction in the monetary aggregates' growth rates. Clearly vindicated have been the recommendations in each of the Banking Committee's last three Monetary Policy Reports that the Federal Reserve resist political pressures for a re-

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turn to discredited fast-growth, inflationary monetary policies that pushed interest rates up in the first place.

Past Monetary Policy Reports have noted that, in both late 1980 and late 1981, faster money growth led to rising interest rates and that those experiences effectively refuted the argument that interest rates could be pushed down with faster money growth.

The sharp decline in interest rates since the last Monetary Policy Report provides additional historical evidence that interest rates were not held up by a "tight" monetary policy, for the decline in rates was not associated with an acceleration of the monetary aggregates' growth rates that could be construed as a "loosening" of monetary policy.

Rather, a decline in interest rates has been impeded by a lack of confidence in the financial markets that the Federal Reserve would persist in its stated objective of gradually slowing the aggregates' growth rates. Ironically, demands for faster money growth have had the perverse impact of holding rates high by contributing to the lack of confidence in the Fed's ability to stick with its now-vindicated policy.

(2) The Federal Reserve's tentative decision to maintain existing money-growth target ranges for the coming year but to seek to bring realized growth down closer to the mid-points of those ranges should permit continued progress toward price stability, lower interest rates and sustainable economic growth.

However, the Committee cautions the Fed about justifying targets by reference to anticipated changes in monetary velocity. Not only would a speed up in money growth designed to offset an expected decline in velocity run the risk of undermining the Federal Reserve's credibility (and, thereby, driving interest rates back up), but the hearings provided a good example of the difficulty of forecasting velocity changes: as already noted, Mr. Maude argued that high interest rates have depressed M–2 velocity while Chairman Volcker argued that lower interest rates also may depress velocity. The Committee also reiterates its conviction that a gradual deceleration of money growth over time is essential to continued progress toward price stability and a return to a sustainably lower level of interest rates.

(3) The Federal Reserve should be applauded for its decisions since the last Monetary Policy Report to implement a system of contemporaneous reserve accounting and to stop the release of seasonally-adjusted weekly M–1 statistics. Since these decisions should improve control of the monetary aggregates and reduce interest rate volatility, the Committee urges the Federal Reserve to proceed as rapidly as possible with the implementation of its decisions. The Committee also urges the Federal Reserve to continue consideration of a formal adoption of a market-oriented discount rate.

(4) While the recent declines in interest rates are evidence that the Federal Reserve has begun to build the credibility of its long-term commitment to gradually slowing the growth of the monetary aggregates, that credibility remains fragile. In such an environment, Congressional proposals to require the Fed to target interest rates and proposals to undermine the Fed's independence run a particularly great risk of causing the financial markets to conclude that the Fed will be forced to return to the discredited policy of trying to force interest rates down through accelerated monetary growth. Such a shattering of the Fed's hard-won credibility would have the perverse effect of driving interest rates back up, not down.

ADDITIONAL VIEWS OF SENATORS RIEGLE, SARBANES, SASSER, AND DODD

The severely depressed state of the economy, including a double-digit unemployment rate for the first time since 1940, is directly attributable to the unprecedent combination of high real interest rates and ballooning budget deficits during the past two years. The Reagan Administration bears primary responsibility for the excessively tight monetary policy and extremely loose fiscal policy which have prolonged and deepened the recission. David Stockman, the President's budget director, when asked by U.S. News and World Report whether the Administration gave Reaganomics credit for the Federal Reserve Board's tight money policy, responded: "We endorsed it; we urged it; we have supported it."

The prime rate was 15.5 percent in late July when the Committee held its oversight hearings on monetary policy. The average mortgage rate was 17 percent and the average municipal bond rate was 12.4 percent. Interest rates have come down slightly since the July hearings, but remain oppressively high. Businesses, farmers, and consumers are suffering the consequences.

Nearly every indicator of real economic activity shows that the long-promised economic recovery is not underway. Business failures are occurring at the highest rate since 1933. The capacity utilization rate in manufacturing is below 70 percent. Auto sales are at a 20-year low, and new private housing starts for 1982 may be fewer than last year—the lowest 1-year total on record. The U.S. merchandise trade deficit was $7.1 billion in August, the highest one-month deficit on record. Mortgage loan delinquencies in the second quarter of 1982 were an all-time record rate, as were foreclosures. The most ominous sign is that the unemployment rate for September 1982 was 10.1 percent.

The Full Employment and Balanced Growth Act of 1978 (the Humphrey-Hawkins Act) requires the Federal Reserve Board to report to the Congress semiannually on monetary policy; it also calls for "an effective policy to promote full employment and production, increased real income, balanced growth." The tight money policy adopted by the Federal Reserve at the behest of the Administration has failed to meet the objectives of the Humphrey-Hawkins Act.

The first reason for the failure of the Federal Reserve's tight money policy was the Administration's failure to present a credible proposal for balancing the federal budget. In September, 1981, the Administration predicted the fiscal year 1982 budget deficit would be $43.1 billion; in September, 1982, the Congressional Budget Office estimated that the actual fiscal year 1982 budget deficit was $112 billion. In July, 1982, the Administration estimated that the fiscal year 1982 budget deficit would be $115 billion; in September, the Congressional Budget Office estimate was $155 billion. In July, 1982, the Administration es-

timated a fiscal year 1984 budget deficit of $92.6 billion: the Congressional Budget Office projected a deficit of $152 billion. By October it became clear that the budget deficits for fiscal year 1983 and fiscal year 1984 would probably be significantly higher than even the Congressional Budget Office estimates.

Large and growing federal deficits are contributing to economic pessimism. Because the federal government's increased borrowing takes up much of the small increases in money supply permitted by the Federal Reserve, tight money has meant much higher interest rates than would have resulted if budget deficits had been lower. Loose fiscal policy has made tight money policy much harder on the economy.

Recommendation: The Administration should ease the Federal Reserve's monetary policy task by presenting a credible proposal for balancing the federal budget, and should begin by making honest projections of the federal deficit.

The second reason the Federal Reserve's monetary policy has badly damaged the economy is that the level of interest rates has been ignored in formulating monetary policy. Both real and nominal interest rates have reached unprecedented levels while the Federal Reserve has focused exclusively on aggregate money supply targets. Historically, positive real interest rates within a range of one to four percent have been associated with periods if balanced economic growth, that is, low unemployment and low inflation rates. During the past two years, real interest rates have generally been in the range of six to ten percent, and nominal rates have ranged from 15 to 20 percent. Extremely high interest rates discourage both business investment and consumer spending, thereby prolonging the economic recession and widening the federal budget deficit.

The additional views to the First Monetary Policy Report (May 5, 1982) stated that: "Given current employment levels and the slack in the economy, there is great leeway for the Federal Reserve Board to reduce interest rates while not exacerbating inflation." At the Committee's monetary policy oversight hearing in July, Federal Reserve Board Chairman Paul Volcker reported that the Federal Open Market Committee had decided that "growth (of the monetary aggregates) somewhat above the targeted ranges would be tolerated for a time." Shortly after the hearing, the Federal Reserve Board reduced the discount rate again—a further signal to the marketplace that the Federal Reserve was willing to tolerate some deviation from its strict money supply targets in order to reduce interest rates.

The Federal Reserve's recent moves to nudge interest rates lower are more than welcome. Given the rising rate of unemployment and lagging production, there appears to be ample room for further interest rate reductions without the risk of higher inflation.

Recommendation: The Federal Reserve should incorporate interest rate targets into monetary policy,and take further steps to bring real interest rates down to historical levels.

Third, the Federal Reserve erred tragically by setting its money supply growth targets too low for 1982. Growth of M1–B in 1981 was well below the bottom of the Federal Reserve's target range of 3.5 to 6 percent. The extremely tight monetary policy pursued in 1981

plunged the economy into a deep recession with rapidly rising unemployment and business failures. The Federal Reserve chose to set a lower target range for 1982 (2.5 to 5.5 percent for M–1 redefined) despite the state of the economy. The Federal Reserve compounded its error by deciding to calculate monetary growth from the very low level of money supply at the end of December, 1981, rather than from the higher level the Federal Reserve had intended to reach by that date. The result was a drastic construction of the "permissible" monetary growth for 1982.

The additional views of the First Monetary Policy Report of 1982 stated: "The Federal Reserve Board's monetary growth targets for 1982, in light of the depressed state of large sectors of the economy and unemployment, are too restrictive to simultaneously allow any substantial relief from high interest rates and make room for stable economic growth." The Federal Reserve's recent tolerance for monetary growth above the upper end of the target range for 1982 is an implicit, but sadly belated, recognition that our warning should have been heeded.

Recommendation: The Federal Reserve Board should set realistic money supply target ranges for 1983, bearing fully in mind the consequences of the error made in 1982 when too low a base was selected for the target range.

Fourth, the Federal Reserve has had great difficulty implementing its narrow focus on monetary aggregates since October 1979, because the forms and uses of money are constantly changing and the instruments available to influence money and credit in the economy are crude. The Federal Reserve has not succeeded in reducing significantly either the growth or volatility of money supply aggregates. As a result, the Federal Reserve has failed to satisfy both monetary economists who would prefer an even narrower and tighter monetary policy and economists who contend that the Federal Reserve's monetarist experiment was too narrowly conceived from the outset.

The Federal Reserve has changed its definition of M–1—the aggregate that is intended to measure transactional balances in the economy—four times in four years. Further definitional adjustments are certain to be needed as types and uses of "money" change. Chairman Volcker's testimony before the Committee cited the difficulty in determining whether NOW account balances should be considered transactional or precautionary balances. Donald E. Maude, Chief Financial Economist for Merrill Lynch, testified that inclusion of NOW accounts in M–1 had improperly inflated the M–1 figures and led the Federal Reserve to pursue too restrictive a monetary policy in 1982:

> It is my view that the M–1 that has been growing way above targets and forcing a restrictive policy thus far this year is not a valid measure of what it has gauged through the "transactional" (or readily spendable) deposits and currency in the system. It is not supposed to include savings-type deposits or balances being built up for precautionary reasons. In the past, M–1 served its purpose well. However, with historically high interest rates and resulting financial innovations over the years, its ability to capture strictly

transactional balances and to exclude savings balances has diminished significantly.

Steven M. Roberts, Director of Government Affairs for the American Express Company and a noted economist, went further. Citing such rapid innovations in financial markets as overnight repurchase agreements, money market funds, Euro-dollars, NOW accounts, and cash management accounts, Robert argued that M–1 should be dropped as a monetary policy target. He testified that:

> It makes no economic sense for the Fed or anyone else to focus attention or a variable whose definition is changing by actions in the market almost daily, whose behavior is impossible to predict, and whose relationship to income, employment, prices, and trade is uncertain.

The recently enacted Depository Institutions Act of 1982 is likely to complicate still further the differentiation of M–1 from M–2. Congress has mandated creation of an account for depository institutions which is "directly equivalent to and competitive with money market mutual funds." The new account is likely to attract funds for both transactional and precautionary purposes, undermining the distinction between M–1 and M–2.

The changing velocity of money also poses a serious challenge for the conduct of monetary policy. Federal Reserve Board Chairman Volcker testified that "M–1 velocity—particularly for periods as short as three to six months—is historically volatile," and that shifts in velocity (changes in the desire for liquidity) would be considered by the Federal Open Market Committee in interpreting changes in the money supply. The Administration's chief spokesman, Council of Economic Advisers, Chairman Murray L. Weidenbaum, argued, however, that such apparent changes in the velocity of money should be ignored: "Unless and until a long-term shift in the money velocity trend becomes apparent, the Federal Reserve should follow a path of stable M–1 growth."

Based on testimony before the Committee, monetary economists do not even agree on what the long-term trend in money velocity is. Weidenbaum testified that:

> Fortunately for policy makers, the underlying growth of M–1 velocity has proven remarkbly constant and predictable for the last several decades. Velocity growth has averaged about 2 percent a year since the beginning of 1981, a figure which is close to the average growth of 3 percent from 1959 to 1981.

Leif H. Olsen, Chairman of the Economic Policy Committee for Citibank, N.A., testified that "the secular or normal trend of velocity currently is estimated to be at about 4 pecent." Given such disparate estimates of velocity, the Federal Reserve is well-advised to take the volatility of money velocity into account when it reviews monetary policy targets.

The Federal Reserve has also been bombarded with recommendations for changes in the technical procedures by which monetary policy is conducted. Examples include: adoption of contemporaneous reserve accounting, elimination of weekly reports of seasonally-ad-

justed estimates of M–1, and formal adoption of a market-oriented discount rate. Changes of this sort may be helpful, but tend to foster the illusion that sound monetary policy consists of mechanical implementation of rigid monetarist formulas. Given all the complexities and uncertainties entailed, a mechanistic approach seems especially inappropriate. Tinkering with the techniques of monetary policy at this point is equivalent to rearranging the deck chairs on the Titanic.

Recommendation: The Federal Reserve should concentrate on a broadly-based, flexible approach to monetary policy consistent with balanced economic growth and should avoid technical "quick-fixes."

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